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In the Supreme Court of the United States

MORGAN STANLEY CAPITAL GROUP INC.,
Petitioner,
v.
PUBLIC UTILITY DISTRICT NO. 1
OF SNOHOMISH COUNTY, WASHINGTON, *ET AL.*,
Respondents.

CALPINE ENERGY SERVICES, L.P., *ET AL.*,
Petitioners,
v.
PUBLIC UTILITY DISTRICT NO. 1
OF SNOHOMISH COUNTY, WASHINGTON, *ET AL.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF OF WILLIAM J. BAUMOL, COLIN C. BLAYDON, CHARLES J. CICCHETTI, JEFFREY A. DUBIN, FRANKLIN M. FISHER, ROBERT W. HAHN, JERRY A. HAUSMAN, WILLIAM W. HOGAN, JOSEPH P. KALT, PAUL R. KLEINDORFER, ROBERT J. MICHAELS, BRUCE M. OWEN, CRAIG PIRRONG, MICHAEL A. SALINGER, STEVEN M. SHAVELL, VERNON L. SMITH, RENÉ M. STULZ, JAMES L. SWEENEY, ROBERT D. WILLIG, AND CATHERINE D. WOLFRAM AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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QUESTIONS PRESENTED

1. Whether the Ninth Circuit erred in holding that the *Mobile-Sierra* doctrine—which affirms the validity of long-term wholesale energy contract rates unless they are shown to be contrary to the public interest—is inapplicable to contracts negotiated in full compliance with FERC's market-based ratemaking regime, unless and until FERC retrospectively concludes that such contracts were negotiated under conditions free from any influence of "market dysfunction."

2. Whether the Ninth Circuit failed to honor *Mobile-Sierra*'s presumption of contract validity when it modified the public interest standard so that wholesale energy contract rates challenged by buyers as too high are modified downward whenever they are outside a zone of reasonableness defined at a later date.

TABLE OF CONTENTS

	Page
Questions Presented	i
Interest Of *Amici*	2
Background	2
I. Suppliers Help Western Utilities Manage The Energy Crisis Through Long-Term Contracts	2
II. The Utilities Seek To Abrogate Their Contracts	6
III. The Ninth Circuit's Decision	7
Summary Of Argument	8
Argument	9
I. Certainty Of Long-Term Energy Contracts Is Of Paramount Importance	9
A. Contract Certainty Is Fundamental To The Nation's Economic Success	9
B. Contract Certainty Is Especially Important For Long-Term Forward Contracts	10
C. Contract Certainty Is Especially Important In The Energy Industry	12
1. Price Volatility In Energy Markets Makes Contract Stability Critical	12
2. Contract Certainty Ensures Development Of Critical Infrastructure	15

TABLE OF CONTENTS—Continued

		Page
II.	Contract Abrogation Should Be Allowed Only In Exceptional Cases	18
	A. The Court Should Not Permit Abrogation Of Market-Based Contracts Merely Because A Price Seems Unreasonably High In Retrospect	19
	B. Claims That A Contract Was Negotiated In A "Dysfunctional Market" Or "Crisis Conditions" Should Not Justify Abrogation	21
	C. Fraud, Manipulation, Or Anticompetitive Conduct Should Justify Abrogation Only In Narrow Circumstances	25
	1. Contracts Should Not Be Abrogated Absent Proof Of Misconduct By One Of The Contracting Parties	26
	2. Contracts Should Not Be Abrogated Absent Proof That The Party's Misconduct Specifically Involved The Long-Term Contract At Issue	29
	3. Existing Remedies Are Sufficient	31
Conclusion		32
Appendix – List Of Signatories		1a

TABLE OF AUTHORITIES

Page

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Page

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INTEREST OF *AMICI*

Amici are leading professors and scholars who teach and write on economic issues and are concerned about the economic effects that the decision below will have on contract certainty in commodities markets. Many have taught, researched, and published analyses of the economics of the electricity industry. Several have also testified in various proceedings about the nature, structure, and appropriate regulation of electricity markets. *Amici* have a particular interest in the role and importance of contract certainty in promoting the proper functioning of markets such as the electricity market.

A summary of the qualifications and affiliations of the *amici* is provided as an appendix to this brief. See App., *infra*, 1a-4a. *Amici* file this brief as individuals and not on behalf of the institutions with which they are affiliated. None of the *amici* is being compensated in connection with this brief.[1]

BACKGROUND

I. Suppliers Help Western Utilities Manage The Energy Crisis Through Long-Term Contracts

This case concerns long-term contracts that were entered into during a period of extreme volatility in the Western electricity market. From mid-2000 through

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[1] The parties have consented to the filing of this brief, and their letters of consent have been filed with the Clerk of the Court. *Amici* state that no counsel for a party authored this brief in whole or in part, and that no such counsel or party made a monetary contribution intended to fund the preparation or submission of the brief. Counsel's fees and expenses incurred to prepare this brief were paid by NRG Energy, Inc. NRG is the parent company of Cabrillo Power I LLC, El Segundo Power LLC, and Long Beach Generation LLC, which have filed a petition for a writ of certiorari (No. 06-1468) now pending before this Court. No other person or entity made a monetary contribution intended to fund the preparation or submission of this brief.

mid-2001, electricity prices in California fluctuated substantially and reached unusually high levels. "Prices in California's competitive wholesale electricity market increased by 500 per cent between the second half of 1999 and the second half of 2000. For the first 4 months of 2001, wholesale spot prices averaged over $300/MWh, ten times what they were in 1998 and 1999." Paul L. Joskow, *California's Electricity Crisis*, 17 Oxford Rev. Econ. Pol'y 365, 365 (2001).

As explained below, volatility is a common feature of electricity markets. The volatility during 2000 and 2001 was of unusual magnitude for a variety of reasons. High temperatures during the summer of 2000 drove up the demand for electricity sharply. See Congressional Budget Office, *Causes and Lessons of the California Electricity Crisis* 11-12 (2001). The drought in the Pacific Northwest in 2000 impeded the generation of hydroelectric power. See Richard J. Pierce, Jr., *How Will the California Debacle Affect Energy Deregulation?*, 54 Admin. L. Rev. 389, 399 (2002). High natural gas prices increased the cost of generating power. *Id.* at 397. California had done a poor job of adding generating capacity in the 1990s. *Id.* at 396. And California's regulatory structure created incentives for wholesalers to exercise market power on the spot market. See Congressional Budget Office, *supra*, at 23-24; Pierce, *supra*, at 400-401.

Two features of California's regulatory regime magnified the effect of those factors. First, California imposed a rate cap that limited the price utilities were allowed to charge consumers. See Cal. Pub. Util. Code § 368(a). That rate cap interfered with the ordinary, long-term price-demand relationship, causing demand to outstrip supply. See Pierce, *supra*, at 397.

Second, before the Western energy crisis, the California Public Utilities Commission had restricted the ability of wholesale electricity purchasers to enter into long-

term forward contracts. See *In re Cal. Power Exch. Corp.*, 245 F.3d 1110, 1116 (9th Cir. 2001). Generally, a buyer can purchase a commodity in one of two ways. It can purchase on the "spot" market, in which case it pays the going price in return for immediate delivery of the commodity. See John C. Hull, *Options, Futures, and Other Derivatives* 3-4 (6th ed. 2006). Alternatively, it can purchase on the "forward" market, in which case it enters into a long-term contract to pay for delivery of the commodity at a specified future date at a price fixed at the time of contracting. See *ibid.* By setting a fixed price in advance, forward contracts allow buyers to "hedge" their financial risk and ameliorate the effects of spot market volatility. See *id.* at 9-10. By restricting the use of long-term forward contracts, California impaired utilities' ability to manage risk and magnified the effect of the energy crisis: When prices rose, California utilities were forced to buy all their power at the increased price on the spot market, with no long-term supply at stable prices to buffer that impact. See Congressional Budget Office, *supra*, at 21-22.

This combination of consumer rate caps and extreme exposure to spot-market volatility had a substantial impact on California utilities. By the end of 2000, the utilities were losing around $50 million a day. Joskow, *supra*, at 381. Following an investigation, FERC found that California's price cap and forward-contract restrictions had contributed substantially to that situation. The price cap, FERC observed, had "thwarted competitive opportunities for new participants to enter the market." *San Diego Gas & Elec. Co.* v. *Sellers of Energy & Ancillary Servs.*, 93 FERC ¶ 61,121, at 61,359 (2000). And the "exposure of California consumers to high prices c[ould] be traced directly to an over reliance on spot markets." *Ibid.* FERC concluded that "[a]n essential remedy is the elimination of rules that," by precluding utilities from

"[m]oving significant amounts of wholesale transactions into forward markets," had "prevent[ed] market participants from managing their risks." *Ibid.* But "California government officials did nothing during the year 2000 to respond to the emerging crises." Joskow, *supra*, at 382. In December, FERC issued another order, emphasizing that "eliminating any mandated reliance on the spot market represents the *single most important aspect of wholesale market reform.*" *San Diego Gas & Elec. Co.* v. *Sellers of Energy & Ancillary Servs.*, 93 FERC ¶ 61,294, at 61,999 (2000) (emphasis added).

That same month, utilities like Snohomish sought to enter into long-term contracts. Pet. App. 26a. In February 2001, California authorized its Department of Water Resources ("CDWR") to purchase energy for its collapsing utilities. *Id.* at 28a. CDWR became the dominant buyer of electricity in California markets. After significant negotiations, it agreed to several long-term contracts that ranged in price and duration. See *Pub. Utils. Comm'n* v. *Sellers of Long Term Contracts*, 99 FERC ¶ 61,087, at 61,377 (2002).

The forward prices at which suppliers offered those long-term contracts were well below the then-prevailing spot prices. See Pierce, *supra*, at 403; Pet. App. 26a-31a. By agreeing to those contracts, CDWR gained several advantages. First, if spot prices rose further (or even stayed at the same level), the long-term contracts would provide a substantial financial benefit by allowing CDWR to receive electricity at prices lower than those prevailing in the spot market. Second, even if spot prices fell, the contracts would have permitted CDWR to reduce risk by allowing it to know, in advance, how much it would have to pay.

II. The Utilities Seek To Abrogate Their Contracts

After the Western energy crisis subsided, spot prices fell. As a result, the forward prices fixed in the long-term contracts were no longer below the prevailing spot prices. See Pierce, *supra*, at 403. A number of buyers commenced proceedings at FERC to modify their contracts. Pet. App. 2a.

FERC resolved those challenges in light of two decisions of this Court that, for half a century, have provided the framework for such claims. See *United Gas Pipe Line Co.* v. *Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956); *FPC* v. *Sierra Pac. Power Co.*, 350 U.S. 348 (1956). The *Mobile-Sierra* doctrine prohibits FERC from setting aside contractually agreed-upon rates as "unjust or unreasonable" unless the rate "conflict[s] with the public interest." *Mobile*, 350 U.S. at 345. Because "[t]he regulatory system created by the [Federal Power] Act is premised on contractual agreements voluntarily devised by the regulated companies[,] it contemplates abrogation of these agreements *only in circumstances of unequivocal public necessity*." *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 822 (1968) (emphasis added).

FERC investigated respondents' claims and found that "there is nothing in the record before the ALJ, in the Staff Final Report, or in the 100-Day Discovery Proceeding evidence to support a finding that there was market manipulation *specific to* the long-term contracts at issue here." *Nev. Power Co.* v. *Enron Power Mktg., Inc.*, 103 FERC ¶ 61,353, at 62,399 (2003); see also *Pub. Utils. Comm'n* v. *Sellers of Long Term Contracts*, 103 FERC ¶ 61,354, at 62,418 (2003); *Nev. Power Co.* v. *Enron Power Mktg., Inc.*, 105 FERC ¶ 61,185, at 61,982 (2003) (on rehearing). FERC stated that respondents' "only basis for contract modification is their dissatisfaction with the bargain," and that, "because there is no evidence of unfairness, bad faith, or duress in the original negotia-

tions, [respondents] are not entitled to change their bargains." *Nev. Power Co.*, 103 FERC at 62,399-400. Accordingly, FERC refused to abrogate the contracts.

III. The Ninth Circuit's Decision

The Ninth Circuit granted respondents' petition for review. Pet. App. 1a-67a. It held that *Mobile-Sierra* would not apply to market-based contracts unless FERC had made a prior determination "that the challenged contract was initially formed free from the influence of improper factors, such as market manipulation, the leverage of market power, or an otherwise dysfunctional market." *Id.* at 57a. The Ninth Circuit did not define what it meant for a market to be "dysfunctional." Nor did it limit the inquiry into misconduct by the parties to the contract themselves. As the court noted, "the local utilities do not allege that the energy companies manipulated their negotiations of the contracts here at issue," but merely "challenge[d] the *context*, not the conduct, of those negotiations." *Id.* at 59a. The Ninth Circuit, moreover, held that a contract could be abrogated even if both contracting parties were aware of the existence of manipulation in the spot market, so long as the "*full scale* of spot market manipulation and forward market dysfunction was not nearly *as fully known* as it is today." *Pub. Utils. Comm'n* v. *FERC*, 474 F.3d 587, 595 (9th Cir. 2006) (emphasis added).

The Ninth Circuit then held that, even when *Mobile-Sierra* applies, the standard for abrogation depends on whether the price is alleged to be too high or too low. For "high price" challenges, the court declared, a contract price may be set aside if it falls above a "'zone of reasonableness' and results in retail rates higher than would be the case if that zone were not exceeded." Pet. App. 65a. The court stated that a more demanding standard would apply if a seller claimed that a contract price was too low. *Id.* at 62a-64a. The court remanded to

FERC for an application of the new standards it had announced. *Id.* at 66a-67a.

SUMMARY OF ARGUMENT

Economists have long recognized that certainty of contract is essential to a healthy economy. Long-term forward contracts, in particular, help reduce financial risk. Those contracts can only accomplish that goal, however, if parties know the contracts will be enforced.

That certainty is especially important in energy markets. Because electricity cannot be stored in large quantities, electricity prices are inherently volatile. Long-term forward contracts allow buyers and sellers to insulate themselves from those price swings, hedging financial risk for both parties. The contracts also guarantee future revenue streams that help electricity producers obtain financing needed to develop necessary infrastructure. Those benefits of long-term forward contracts cannot accrue in a legal environment where parties cannot be sure their contracts will be enforced. The Ninth Circuit's approach threatens important tools for managing risk in the energy industry.

The Ninth Circuit's approach is particularly pernicious where, as here, long-term contracts are entered into during a market crisis. Long-term contracts are a *remedy* for crisis conditions because they allow buyers to reduce the risk posed by extreme volatility in spot markets. Sellers cannot be expected to enter into long-term contracts during a crisis—forgoing profits they would otherwise make by selling in spot markets—if their contracts will not be respected.

From an economic and policy standpoint, long-term energy contracts should be abrogated only in truly exceptional circumstances. The mere fact that a price seems too high in retrospect does not justify abrogating contracts voluntarily agreed to by sophisticated buyers

and sellers. Nor do generalized claims of "market dysfunction" at the time the contract was formed. The term "market dysfunction" has no fixed meaning and, in cases like this one, is all too easily invoked to seek abrogation of contracts that were formed precisely when certainty is needed most—in crisis conditions, where the stability provided by long-term commitments is crucial. Finally, while fraud or manipulation *by one of the contracting parties themselves* might justify abrogation *if the misconduct specifically involved the long-term contract at issue*, there are already ample remedies for misconduct of that nature, and there is thus no need to craft new regulatory exceptions to contract certainty.

ARGUMENT

I. CERTAINTY OF LONG-TERM ENERGY CONTRACTS IS OF PARAMOUNT IMPORTANCE

Since the time of the Nation's founding, most of the economic activity essential to the national welfare has been based on voluntary agreements among individuals. Those agreements would be meaningless without effective means to enforce them.

A. Contract Certainty Is Fundamental To The Nation's Economic Success

Centuries ago, Adam Smith recognized that certainty of contract is essential to economic development. Contracting in the face of uncertain enforcement, he argued, made voluntary agreements too risky to be worthwhile: "When the law does not enforce the performance of contracts," he explained, "it puts all borrowers nearly upon the same footing with bankrupts * * *." Adam Smith, *The Wealth of Nations* bk. I, ch. IX, at 133 (Edwin Cannan ed., Bantam Dell 2003) (1776).

The Framers likewise understood the necessity of contract stability. They considered the sanctity of contracts so important that they included a clause in the Constitu-

tion specifically prohibiting contract abrogation: "No state shall * * * pass any * * * law impairing the obligation of contracts." U.S. Const. art. I, § 10, cl. 1. And Congress later recognized that the right to enter into enforceable contracts is a necessary component of full economic participation, when it provided that all citizens "shall have the same right * * * to make and enforce contracts" regardless of race. Civil Rights Act of 1866, ch. 31, § 1, 14 Stat. 27, 27.

Modern economists have since elaborated on those themes, but the basic principle remains the same: The "fundamental function of contract law" is to "encourage the optimal timing of economic activity" by "deter[ring] people from behaving opportunistically toward their contracting parties." Richard A. Posner, *Economic Analysis of Law* 91 (4th ed. 1992); see also Daniel A. Farber, *Contract Law and Modern Economic Theory*, 78 Nw. U. L. Rev. 303, 315 (1983); L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages*, 46 Yale L.J. 52, 59 (1936). That function cannot be accomplished without effective means for enforcement. As this Court has stated: "Market efficiency requires effective means to enforce private agreements." *Am. Airlines, Inc.* v. *Wolens*, 513 U.S. 219, 230 (1995).

B. Contract Certainty Is Especially Important For Long-Term Forward Contracts

Contract certainty is particularly important where long-term forward contracts are at issue. As explained above, p. 4, *supra*, commodity buyers and sellers often enter into long-term forward contracts to manage risk. A forward contract is an agreement for the delivery of a commodity in the future at a specified price. See Hull, *supra*, at 3-4. By agreeing to a fixed price ahead of time, rather than waiting to purchase the commodity at some unknown price in the spot market, buyers can "hedge" their financial risks. See *id.* at 9-10. Sellers correspond-

ingly gain the certainty of a guaranteed income stream regardless of changes in demand. See *ibid.* Forward contracts thus are all about providing certainty—avoiding risk—for both sides.

Because risk avoidance is desirable in its own right, firms will often enter into long-term contracts even where the contracts are not expected to save the purchaser money in comparison to buying exclusively on the spot market. See Hull, *supra*, at 9-10; Lingxiu Dong & Hong Liu, *Equilibrium Forward Contracts on Nonstorable Commodities in the Presence of Market Power*, 55 Operations Res. 128 (2007); David B. Spence, *The Politics of Electricity Restructuring: Theory vs. Practice*, 40 Wake Forest L. Rev. 417, 438 (2005). Indeed, if firms are sufficiently risk averse, they may be willing to pay more under a long-term contract than they expect to pay on the spot market. See Hany A. Shawky *et al.*, *A First Look at the Empirical Relation Between Spot and Futures Electricity Prices in the United States*, 23 J. Futures Markets 931, 941-942 (2003).

Forward markets cannot function, however, if parties are unsure whether the contract will be enforced. The terms of a forward contract will often become onerous for one of the parties during the life of the contract: If spot prices fall, the buyer may wish to purchase on the spot market rather than fulfill its bargain to purchase at the agreed-upon price. Conversely, if spot prices rise, the seller may wish it could renege. Unless each party knows at the outset that the other will almost always be bound by the contract, neither would have any incentive to agree to the forward contract in the first place, and the risk-reducing benefits of long-term forward contracts would be lost.

C. Contract Certainty Is Especially Important In The Energy Industry

The need to manage risk by ensuring contract certainty is particularly important in the energy industry. Energy markets are inherently volatile. Because dramatic price swings threaten substantial financial risks for buyers and sellers, enforceable forward contracts are particularly important to hedge risk in those markets. The energy industry, moreover, is exceedingly capital-intensive, requiring enormous outlays for infrastructure development that may take years or decades to recoup. Contracts—particularly long-term forward contracts—are indispensable to provide the certainty necessary to encourage such enormous long-term investments.

1. *Price Volatility in Energy Markets Makes Contract Stability Critical*

Contract certainty is crucial in the electric industry because of the inherently volatile nature of electricity spot markets. Multiple factors contribute to that volatility. Unlike other commodities, energy cannot be economically stored in large quantities. See Shawky *et al.*, *supra*, at 932. As a result, supply and demand must be in constant equilibrium—there is no electricity inventory that could be used to meet sharp increases in demand. Additionally, the demand for electricity is extremely inelastic in the short term, even though a wide variety of unpredictable factors such as temperature may cause wild fluctuations in usage. As a result, a "properly-functioning, fully-competitive electricity market is likely to yield market prices that vary by a factor of ten or twenty to one in a single day." Pierce, *supra*, at 395.

The Western energy crisis vividly illustrates the volatility of electricity markets, and the many different factors that can have severe effects on prices. See p. 3, *supra*. But volatility is common to all electricity markets.

New England, for example, saw highly volatile spot market energy prices in January 2004 as frigid temperatures put upward pressure on demand. See FERC, *2004 State of the Markets Report* 13-24 (2005). And the price of electricity in the Midwest wholesale spot market also dramatically increased during June 1998. See FERC, *Staff Report to the Federal Energy Regulatory Commission on the Causes of Wholesale Electric Pricing Abnormalities in the Midwest During June 1998* (1998).

Long-term contracts are essential to allow electricity providers to weather the uncertainties of the inherently volatile market in which they participate. Reflecting that, forward contracts "represent the majority of instruments used for risk management" in the electricity market. Alexander Eydeland & Krzysztof Wolyniec, *Energy and Power Risk Management* 34 (2003).

The need for contract certainty to deal with price volatility has been amplified by the shift toward a market-based pricing regime. In a cost-based regime, energy suppliers have little incentive to reduce costs or limit production to the level of consumer demand, and accordingly often have excess capacity. For example, before the reforms of the 1990s, "[e]lectricity prices were high in California partly because the regulated market, by assuring producers of a high rate of return on their investments, provided incentives to build too much generating capacity." Congressional Budget Office, *supra*, at 1. That excess capacity imposed wasteful costs that were passed on to consumers:

> One of the reasons that the state moved to a competitive market structure was to help reduce electricity prices by lowering the costs of the utilities' reserve capacity. In a competitive market, producers' investment in reserve capacity should be consistent with the amount of price stability (or, equivalently, supply security) that consumers are will-

> ing to pay for in the form of long-term supply contracts.

Id. at 32; see also Pierce, *supra*, at 393 (noting that the California electricity market was "characterized by excess capacity, high costs, and regulated prices that were approximately twice as high as the prices that would exist in an unregulated market"); Stephen Breyer, *Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reform*, 92 Harv. L. Rev. 549, 562-565 (1979) (discussing the inefficiencies of cost-of-service ratemaking). Market-based regimes reduce those inefficiencies by inducing suppliers to calibrate supply to demand more closely.

One result of that efficiency improvement, however, is that there tends to be less excess capacity to dampen volatility. Long-term contracts allow firms to manage the greater volatility that accompanies market-based pricing by guaranteeing that at least part of their needs will be met at a fixed price regardless of short-term conditions.

The Western energy crisis of 2000-2001 was exacerbated by California's former obstacles to long-term contracts and its cap on consumer energy prices. Those restrictions "created a financial disaster for the investor-owned utilities when wholesale electricity prices began to rise." Congressional Budget Office, *supra*, at 18. Rate caps imposed losses on utilities when the spot price exceeded the amount the utilities could charge consumers. *Id.* at 19. When those conditions persisted, utilities faced a credit crunch because they were buying electricity at much higher costs than they could sell it, resulting in downgraded credit ratings that made borrowing even more expensive. *Id.* at xi. That financial crisis would have been mitigated if the utilities had hedged their market risk by entering into long-term contracts with wholesale electricity suppliers. See Spence, *supra*, at 439

("Had PG&E and SCE protected themselves against price risk [by hedging], the damage done to their credit ratings (and the consequent exacerbation of the supply crisis that grew out of the credit problem) might have been reduced.").

2. *Contract Certainty Ensures Development Of Critical Infrastructure*

Contract certainty is also crucial in the energy industry to ensure that necessary infrastructure is built. The Nation currently faces explosive growth in demand for electricity. According to the Department of Energy, electricity sales are projected to grow by 28% to 54% from 2005 to 2030. Energy Info. Admin., *Annual Energy Outlook 2007: With Projections to 2030*, at 82 (2007). "Growth in population and disposable income is expected to lead to increased demand for products, services, and floorspace, with a corresponding increase in demand for electricity for space heating and cooling and to power the appliances and equipment used by buildings and businesses." *Ibid.* "[A]ll electricity demand regions * * * are expected to need additional, currently unplanned, capacity by 2030." *Id.* at 84.

Massive expenditures in energy infrastructure are needed over the next fifteen years to meet that rapidly rising demand. The electric industry, however, is "inherently capital-intensive." Amy Abel, *Electric Transmission: Approaches for Energizing a Sagging Industry, CRS Report for Congress* 1 (2007). Vast outlays of financial resources are required for electric power production and delivery. Generation, transmission, and distribution all require years of investment in infrastructure. Those investment costs may not be recouped for decades, particularly in light of the fluctuating "boom" and "bust" cycles that characterize the industry. See Lawrence J. Makovich, *California Power Crisis Aftershock: The Potential Modification of Western Power*

Contracts 9 (2007), *available at* http://www2.cera.com/westernpowercontracts ("Given the long power plant development lead times, * * * investment decisions must be made years in advance of operation, and * * * capital cost recovery must span numerous market cycles.").

Electricity producers will not invest the extraordinary resources needed to develop new energy sources without some assurance that they will recoup their investment. Contracts that guarantee future revenue streams can provide that assurance—but only if the energy producer can be certain that the contracts will be enforced. As FERC has stated, "[c]ompetitive power markets simply cannot attract the capital needed to build adequate generating infrastructure without regulatory certainty, including certainty that the Commission will not modify market-based contracts unless there are *extraordinary* circumstances." *Nev. Power Co.* v. *Duke Energy Trading & Mktg., L.L.C.*, 99 FERC ¶ 61,047, at 61,190 (2002); see also Stephen L. Teichler & Ilia Levitine, *Long-Term Power Purchase Agreements in a Restructured Electricity Industry*, 40 Wake Forest L. Rev. 677, 699 (2005) (noting that long-term contracts are "critical" to "encourage investments in aging infrastructure"). Without contract certainty, long-term investment in desperately needed infrastructure will be held back, and the spiraling demand for energy will go unmet.

Contract certainty is also crucial when a contracting party is an energy merchant rather than the ultimate power generator. These financial intermediaries perform a vital role by providing a ready market for the purchase and sale of electricity. See FERC, *2004 State of the Markets Report* 64 (2005) (reporting that the proliferation of energy trading firms had "increased capital available to market participants" and thereby "improved the industry's ability to address credit issues, increased the ability of companies to buy and sell energy, and increased mar-

ket liquidity"). Without contract certainty, those institutions also would not be able to function.

The California experience confirms that reliable long-term contracts are critical to infrastructure development. As the Congressional Budget Office stated:

> Had the utilities been able to enter into long-term contracts that guaranteed their future cost or supply of electricity, such arrangements would have helped diminish the shortage of power-generating capacity—and thus reduced the upward pressures on prices. Such long-term guarantees would have encouraged independent generators to build new capacity and would have improved the utilities' financial position, so generators might not have charged higher prices as compensation for the risk of nonpayment by the utilities.

Congressional Budget Office, *supra*, at 22.

Long-term contracts play a critical role in infrastructure development in other ways as well. A generator of electricity faces high sunk costs upon entering the market. Long-term contracts ease new entry: They may be used to obtain credit, permitting a new entrant to sell its future output to raise capital for the initial investment or to expand generating capability. See Congressional Budget Office, *supra*, at xi, 22. The resulting competition from new entrants decreases the threat that any one supplier will exercise market power, and thus promotes market efficiency. See Steven Stoft, *Power System Economics: Designing Markets for Electricity* 335 (2002); *Tops Mkts., Inc.* v. *Quality Mkts., Inc.*, 142 F.3d 90, 98-99 (2d Cir. 1998) ("relative ease of competitive entry" impedes market power).

Long-term contracting will not occur if those contracts are not enforceable. If the optimal level of infrastructure does not get built, the likelihood of future crises will increase dramatically.[2]

II. CONTRACT ABROGATION SHOULD BE ALLOWED ONLY IN EXCEPTIONAL CASES

Given the critical role of electricity in the U.S. economy, and the vital function that long-term contracts play in electricity markets, those contracts should be respected in all but the most exceptional circumstances. In this case, however, the Ninth Circuit announced new conditions that make those contracts much less certain and therefore both more expensive and less desirable. The Ninth Circuit held that *Mobile-Sierra*—the doctrine that has ensured contract certainty for 50 years—does not apply unless there has been a prior investigation and determination that the market is not "dysfunctional." Pet. App. 57a. The court further held that, even where *Mobile-Sierra* applies, a contract can be abrogated if the price falls above some ill-defined "zone of reasonableness." *Id.* at 65a. Those tests fall far short of an economically appropriate standard.

The mere fact that a price seems too high in retrospect does not justify courts or agencies in second-guessing trading decisions voluntarily made by sophisticated buyers and sellers in energy markets. Nor do generalized claims of market "dysfunction." Although fraud or manipulation by *one of the contracting parties themselves* might justify abrogation if it *specifically involves* the

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[2] Contract certainty, especially for long-term contracts, is crucial in the gas industry for similar reasons. See Richard J. Pierce, *Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry*, 97 Harv. L. Rev. 345, 356 (1983) ("Long-term contracts allow parties to bargain for the socially optimum mix of price and supply security.").

long-term contract at issue, the law already provides ample remedies for misconduct of that nature. There is thus no need to create new sources of contract uncertainty by expanding the potential for abrogation under *Mobile-Sierra*.

The Ninth Circuit's test would effectively punish sellers even if only misconduct *by third parties* affected the market. That test will deter the very conduct the law should encourage—namely, sellers helping energy buyers hedge their financial risk by offering long-term contracts. And the Ninth Circuit's test will deter that market-stabilizing conduct precisely when it matters most—in crisis conditions of high price volatility.

A. The Court Should Not Permit Abrogation Of Market-Based Contracts Merely Because A Price Seems Unreasonably High In Retrospect

Review of a forward contract under the *Mobile-Sierra* "public interest" standard should not focus on the reasonableness of the particular price agreed to. Parties to long-term contracts always operate in the face of incomplete information, both about the current state of the world and about what the future may bring. Long-term contracts are a method of allocating those inevitable risks. The buyer bears the risk that future spot prices will decrease, while the seller assumes the risk that future spot prices will increase. New information that affects price levels does not mean the price agreed to was unreasonable; the whole point of a long-term contract is to fix the price *despite* future price fluctuations that new information may cause.

Courts and agencies have limited institutional competence to assess the "reasonableness" of prices voluntarily agreed to by sophisticated buyers and sellers who make such trading decisions every day. That is especially true in energy markets, where prices fluctuate substantially

in the short term. See pp. 12-14, *supra*. As this Court recently observed, "sophisticated businesses enjoying presumptively equal bargaining power" can be "expected to negotiate a 'just and reasonable' rate as between the two of them." *Verizon Commc'ns Inc.* v. *FCC*, 535 U.S. 467, 479 (2002). Neither courts nor regulators can reliably reconstruct, years after the fact, the complete set of circumstances that led two contracting parties to conclude that a particular price level was in both of their best interests.

A focus on the reasonableness of particular price outcomes has been avoided in other contexts as well. In antitrust cases, for example, this Court has held that its precedents "unequivocally foreclose an interpretation of the Rule [of Reason] as permitting an inquiry into the reasonableness of the prices set by private agreement." *Nat'l Soc'y of Prof'l Eng'rs* v. *United States*, 435 U.S. 679, 689 (1978); *United States* v. *Addyston Pipe & Steel Co.*, 85 F. 271, 282-283 (6th Cir. 1898), *aff'd as modified*, 175 U.S. 211 (1899). Similarly, when evaluating a commercial impracticability defense, courts reject reliance on the reasonableness of a particular agreed-upon price level. Impracticability defenses generally fail when based solely on a change in market conditions, especially when parties have allocated the risk in the contract:

> [A] fixed-price contract is an explicit assignment of the risk of market price increases to the seller and the risk of market price decreases to the buyer * * * . If * * * the buyer forecasts the market incorrectly and therefore finds himself locked into a disadvantageous contract, he has only himself to blame and so cannot shift the risk back to the seller by invoking impossibility or related doctrines.

N. Ind. Pub. Serv. Co. v. *Carbon County Coal Co.*, 799 F.2d 265, 278 (7th Cir. 1986) (Posner, J.).

The very nature of a forward contract is to allocate price risk. Attempting to evaluate the propriety of that allocation through a post-hoc assessment of the price's reasonableness undermines the parties' goal of allocating risk. By requiring abrogation of contracts voluntarily agreed to by sophisticated buyers and sellers merely because the price seems above some poorly defined "zone of reasonableness" in retrospect, the Ninth Circuit's rule thrusts courts and agencies into a role they are ill-equipped to handle and should not be undertaking.

B. Claims That A Contract Was Negotiated In A "Dysfunctional Market" Or "Crisis Conditions" Should Not Justify Abrogation

Mere generalized claims of "market dysfunction" or "crisis conditions" also cannot justify contract abrogation. Extreme market conditions can and do occur, particularly in markets as volatile as the electric spot market. See pp. 12-14, *supra*. Those conditions do not undermine the rationale, or the need, for contract certainty. To the contrary, long-term contracts are the *remedy* for uncertainty and the *cure* for volatility.

The main reason for entering into long-term contracts is to hedge risk. The ability to hedge risk is most important precisely when a market is facing crisis conditions. If one party to a contract could revisit its bargain midstream, market participants would lose confidence in their ability to hedge price risk. And if a market crisis or other abnormal conditions justified abrogation, market participants would see their price hedge evaporate just when they need it most—in times of substantial volatility. That is akin to losing fire insurance on one's home whenever the fire damage becomes severe.

Abrogating contracts agreed to during periods of high volatility creates exactly the wrong incentives. Long-term forward contracts *ameliorate* market crises by pro-

viding price stability in the face of rapidly changing conditions. They not only allow firms to manage the volatility of existing crises, but also lay the foundations that avoid future ones. See pp. 15-18, *supra*. For those reasons, the law should do everything possible to *encourage* long-term contracts in periods of extreme volatility, not render those contracts useless—and thus potentially unavailable—by leaving contracting parties to speculate about whether their agreements will later be upheld. Adam Smith recognized over 200 years ago that the absence of means to enforce contracts renders all purchasers the functional equivalent of "bankrupts." See p. 9, *supra*. The Ninth Circuit's rule turns buyers into "bankrupts" precisely when their ability to purchase matters most—in crisis conditions.

Market "dysfunction" is a particularly pernicious basis for abrogation because it has no well-defined meaning. Contracting parties and courts will inevitably disagree over what conditions constitute "dysfunction." Price phenomena that appear abnormal are often entirely natural consequences of supply and demand. Because high volatility is a normal feature of electricity markets, for example, price spikes do not necessarily reflect market dysfunction. See Robert J. Michaels & Jerry Ellig, *Price Spike Redux: A Market Emerged, Remarkably Rational*, Public Utilities Fortnightly, Feb. 1, 1999, *available at* http://www.pur.com/pubs/3132.cfm; Makovich, *supra*, at 24. Nor do sales at levels that exceed marginal cost. See Scott M. Harvey & William W. Hogan, *Market Power and Withholding* 4, 11 (2001), *available at* http://ksghome.harvard.edu/~whogan; Stoft, *supra*, at 372 (noting that even a supplier who makes high profits for several consecutive years does not necessarily exercise market power). Economists disagree about what role market power or manipulation played in spot markets during the California energy crisis. Compare, *e.g.*, Scott

M. Harvey & William W. Hogan, *Market Power and Market Simulations* (2002), *available at* http://ksghome.harvard.edu/~whogan, with Paul L. Joskow & Edward Kahn, *A Quantitative Analysis of Pricing Behavior in California's Wholesale Electricity Market During Summer 2000*, 23 Energy J. 1 (2002). Yet contracting parties will inevitably allege these sorts of conditions as grounds for repudiating a contract that turns unfavorable.

Although buyers in some markets might complain that a seller had market power, this Court has made clear that "[t]he mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system." *Verizon Commc'ns Inc.* v. *Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407 (2004). And the mere possession of market power does not necessarily mean that it was exercised. See Paul Twomey *et al.*, *A Review of the Monitoring of Market Power* 8 (MIT Ctr. for Energy & Envtl. Policy Research, Working Paper No. 05-002, 2005).

This very case provides an example of how amorphous the concept of market dysfunction can be. The Administrative Law Judge below found that the forward markets were "competitive," "not dysfunctional," and "well functioning." *Nev. Power Co.* v. *Enron Power Mktg., Inc.*, 101 FERC ¶ 63,031, at 65,288 (2002). In both this case and a companion case, FERC found that "there is nothing in the record before the ALJ, in the Staff Final Report, or in the 100-Day Discovery Proceeding evidence to support a finding that there was market manipulation *specific to* the long-term contracts at issue here." *Nev. Power Co.* v. *Enron Power Mktg., Inc.*, 103 FERC ¶ 61,353, at 62,399 (2003); *Pub. Utils. Comm'n* v. *Sellers of Long Term Contracts*, 103 FERC ¶ 61,354, at 62,418

(2003).[3] Nonetheless, the Ninth Circuit overturned FERC's decision, holding that FERC had failed to determine whether "the challenged contract was initially formed free from the influence of improper factors, such as market manipulation, the leverage of market power, or an otherwise dysfunctional market." Pet. App. 57a. And in the companion case, the Ninth Circuit went so far as to question the validity of a properly filed contract merely because, at the time the contract was filed, "the *full scale* of spot market manipulation and forward market dysfunction was not nearly *as fully known* as it is today." *Pub. Utils. Comm'n* v. *FERC*, 474 F.3d 587, 595 (9th Cir. 2006) (emphasis added). Contract certainty should not be upset merely because more is "fully known" today than was known years before.

If a court or agency can abrogate a contract based on its *post hoc* determination that a market was generally "dysfunctional," sellers will either charge more to cover the potential future cost of litigation, enforcement, and abrogation, or—particularly if rate caps or other constraints preclude price increases—will simply not offer long-term contracts at all. The first alternative results in higher prices for consumers; the second leaves consumers and retailers with no protection against the volatile spot market prices inherent in the electric industry. Both results are economically inefficient. Given the high price volatility of the spot market and the massive amount of infrastructure investment needed over the

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[3] While prices can rise above long-run marginal cost for extended periods even in well-functioning markets, plaintiffs in the companion case, *Dynegy Power Marketing, Inc.* v. *Public Utilities Commission*, No. 06-1468 (filed May 3, 2007), failed to prove even that the CDWR contracts they sought to abrogate were at elevated prices. See *Pub. Utils. Comm'n*, 103 FERC at 62,415 ("Complainants were unable to demonstrate that the contracts were priced above long-run competitive prices.").

next several decades, see pp. 12-18, *supra*, the potential additional costs to consumers would be very high. That new cost burden is entirely avoidable if the underlying risk of contract uncertainty is eliminated.

The Ninth Circuit's approach would not only harm energy markets, but also have far-reaching effects in other commodity markets in the United States and elsewhere. Buyers and sellers throughout the global economy now hedge a very large number of commodity transactions with forward contracts or other derivative instruments. See Hélyette Geman, *Commodities and Commodity Derivatives* 21-22 (2005). A ruling affirming the Ninth Circuit's decision—even if nominally limited to electricity markets—could call into question this country's commitment to contract certainty generally. The results for international trade could be very significant. In many developing nations, contract uncertainty imposes substantial surcharges on capital costs. See Kenneth W. Hansen, *PRI and the Rise (and Fall?) of Private Investment in Public Infrastructure*, in *International Political Risk Management: The Brave New World* 75, 87-90 (Theodore H. Moran ed., 2004). The Ninth Circuit's approach threatens to create the same type of costs here.

C. Fraud, Manipulation, Or Anticompetitive Conduct Should Justify Abrogation Only In Narrow Circumstances

Finally, claims that a contract should be abrogated or modified because of fraud, manipulation, anticompetitive conduct, or the like should also be viewed with suspicion. Even if such factors might sometimes justify contract modification, those circumstances should be carefully defined and limited. Such misconduct should not justify abrogation or modification unless two conditions are met. First, one of the contracting parties *itself* must be proved to have engaged in misconduct. Second, even where that is shown, the misconduct should not justify abrogation

absent proof that it specifically involved the contract at issue. Existing legal remedies are more than adequate to address those circumstances. There is thus no reason to create new sources of regulatory uncertainty by expanding the potential for abrogation under *Mobile-Sierra*.

1. *Contracts Should Not Be Abrogated Absent Proof Of Misconduct By One Of The Contracting Parties*

In virtually all markets for a wide range of products, there are instances of market manipulation, anticompetitive conduct, or other misconduct by various market participants. These are simply examples of the many different factors that may influence prices. Some types of conduct may be beneficial; others are discouraged, and the legal system is structured to deter them accordingly. But the binding nature of a contract between parties who have not *themselves* engaged in misconduct should not be conditioned on a finding that the market is free of any influences the legal system seeks to discourage.

It is, in fact, particularly important for contracts to be binding in those circumstances. Like other sources of market "dysfunction," manipulation by third parties increases volatility and uncertainty. Thus, just like other sources of volatility, manipulation increases the need for mechanisms that reduce risk. Long-term contracts fulfill that need. But those contracts cannot perform that function—and thus may not be available at all—if contracting parties cannot be sure the contracts will be enforced.

Indeed, long-term contracts often ameliorate the misconduct. A reliable forward market, for example, tends to make the spot market more competitive. "Locking in some sales in advance reduces the incentives of multiple firms to behave less competitively among themselves." Severin Borenstein, *The Trouble With Electricity Markets: Understanding California's Restructuring Disas-*

ter, 16 J. Econ. Perspectives 191, 202 (2002) (citing Blaise Allaz & Jean-Luc Vila, *Cournot Competition, Forward Markets and Efficiency*, 59 J. Econ. Theory 1 (1993)); see also Stoft, *supra*, at 80 (noting that long-term contracts "can greatly increase competitiveness in the spot market"). Locking in buyers and sellers to long-term contracts at fixed prices can also help prevent manipulation. See Richard J. Pierce, Jr., *Completing the Process of Restructuring the Electricity Market*, 40 Wake Forest L. Rev. 451, 474 (2005) (describing long-term contracts as "the most effective means of protecting [utilities] from the risk of unilateral withholding"). Finally, long-term contracts encourage infrastructure development and thus increase sources of supply. See pp. 15-18, *supra*. That reduces the impact of any individual participant's misconduct on the market.

To take just one example, OPEC routinely engages in anticompetitive conduct that would violate U.S. antitrust laws, and that indisputably distorts energy markets. But that misconduct does not mean long-term contracts between *other* parties should be abrogated merely because prices would have been different in OPEC's absence. See *Eastern Air Lines, Inc.* v. *Gulf Oil Corp.*, 415 F. Supp. 429, 441 (S.D. Fla. 1975) (rejecting a claim that OPEC's exercise of market power and the ensuing "so-called energy crises" justified abrogating a contract under the commercial impracticability doctrine). The risk-reducing benefits of long-term contracts are no less important than they would be in a perfectly competitive energy market. In fact, they are even more important: Long-term contracts ameliorate the effects of OPEC's actions by encouraging development of *other* sources of supply.

By directing FERC to investigate "the *context*, not the conduct, of [the] negotiations," Pet. App. 59a, the Ninth Circuit adopted a standard that justifies abrogation even when the contracting parties themselves are entirely in-

nocent of any misconduct. The fact that non-OPEC members sell into a market affected by OPEC's cartel does not mean those non-OPEC members should have their contracts abrogated. Likewise, parties offering long-term contracts to buyers amid claims of third-party manipulation in spot markets are not somehow complicit in that manipulation. To the contrary, they are providing the *antidote* for the manipulation by offering long-term contracts that bring stability. When there is a fire, the law should punish the arsonist, not the fireman. Otherwise no one will show up to help put out the fire next time.

The Ninth Circuit's standard creates precisely the wrong incentives. Energy suppliers should be *encouraged* to offer long-term contracts that reduce risk, not deterred from doing so. It is not reasonable to expect innocent parties to reject mutually satisfactory offers merely because some unknown third party might be influencing market prices. If such a standard were upheld, parties would be discouraged from entering into long-term contracts whenever they believed that a court or agency might make a finding of fraud, manipulation, or "dysfunction" by unknown third parties at some future date. That deterrence of beneficial risk-reducing contracts serves no rational policy purpose. If the Ninth Circuit's rule is upheld, the next time there is an energy crisis, suppliers will simply refuse to offer long-term contracts to utilities, or will require premiums to account for the legal risks that substantially increase the contracts' costs. The result will be more volatility, less infrastructure development, and ultimately higher prices for utilities and consumers.

The Ninth Circuit's standard is particularly irrational in cases where both parties were aware of allegations of market manipulation when they entered into the contract, and were merely uncertain about the manipula-

tion's extent. In the companion case below, for example, the Ninth Circuit questioned the validity of a filed contract because "the *full scale* of spot market manipulation and forward market dysfunction was not nearly *as fully known* as it is today." *Pub. Utils. Comm'n*, 474 F.3d at 595 (emphasis added). But the purpose of forward contracts is to allocate such difficult-to-assess risks. Abrogating the contract changes the allocation of risk that the parties voluntarily agreed to.

2. *Contracts Should Not Be Abrogated Absent Proof That The Party's Misconduct Specifically Involved the Long-Term Contract At Issue*

Contracts also should not be abrogated absent proof of misconduct specific to the contract at issue. Any other standard creates incentives for opportunistic behavior by counterparties that will undercut contract certainty.

Claims that a party manipulated the price of a long-term forward contract should be viewed with suspicion. It is difficult to manipulate or exercise market power in long-term forward markets. Both buyers and sellers have many options: They can continue buying in spot markets, they can do business with other counterparties, and depending on the time horizon they can often self-supply. The longer the term of the contract, the more options exist. Long-term contracts thus are inherently resistant to manipulation or the exercise of market power.

Long-term forward contracts for electricity are particularly resistant to manipulation or the exercise of market power. Where a commodity is storable, a close relationship generally exists between spot prices and forward prices because of arbitrage constraints. If forward prices are too high relative to spot prices, traders can purchase the commodity in the spot market while contracting to sell it in the forward market; they can then store the commodity purchased in the spot market and later use it

to satisfy their obligations under the forward contract. That arbitrage by traders will tend to keep forward and spot prices in equilibrium. See Hull, *supra*, at 14.

Because electricity is not economically storable, however, the spot price is far more independent from the long-term forward price. See Petter Skantze & Marija Ilic, *The Joint Dynamics of Electricity Spot and Forward Markets: Implications on Formulating Dynamic Hedging Strategies* § 2.4.3 (MIT Energy Lab. Report, No. MIT_EL 00-005, 2000) ("Since electricity is not storable * * * the dynamic relationship between the spot and forward price described above does not hold for electricity."); Shawky *et al.*, *supra*, at 932 ("The inability to store electricity means that the well known cost-of-carry relationship that links spot and forward prices cannot be used * * * ."). As a result, manipulation in the spot market will *not* have the same effect on the price of long-term forward contracts that it might in other industries. Cf. Skantze & Ilic, *supra*, § 2.4.3 ("If it were announced today that a major nuclear plant in New England would be out of commission for the month of July, this would cause an immediate increase in today's price of a forward contract with delivery in July. However it would have no effect on the current spot price."); *San Diego Gas & Elec. Co.*, 93 FERC at 61,994 (stating that the effect of input costs on long-term contract prices "will be based on analysis and expectations for next summer, and not last summer"). For that reason, manipulation of spot prices in electricity markets cannot alone justify any inference that long-term contract prices were affected. But that is precisely the sort of inference the Ninth Circuit relied on here. Pet. App. 57a-60a.

Absent proof of manipulation or other misconduct specific to the forward contract at issue, it would be all too easy for a party to escape its contractual obligations by alleging misconduct by its counterparty. The possibility

of such claims, and the necessity of litigating them, will damage the certainty that forward contracts require to function. Thus, proof of misconduct specifically involving the contract at issue must be required.

3. *Existing Remedies Are Sufficient*

In short, from an economic and policy perspective, market dysfunction or manipulation should justify abrogation of a long-term contract only when a contracting party proves that another party to the contract itself engaged in misconduct specifically involving the long-term contract at issue. Given that, there is no need to modify *Mobile-Sierra* to provide new remedies; crafting new remedies to protect contract parties from fraud or manipulation is a solution in search of a problem. FERC should instead employ existing legal mechanisms, such as prohibitions against fraud and market manipulation. See, *e.g.*, 7 U.S.C. § 2(h)(2)(B)-(C) (prohibiting fraud and manipulation); 16 U.S.C. § 824v (prohibiting energy market manipulation); 18 C.F.R. § 1c.2 (prohibiting fraud and manipulation in electric energy markets).[4] Alternatively, any exception to the *Mobile-Sierra* public interest test should be limited, in this context, to circumstances that would justify a remedy under those analogous traditional legal doctrines.

The standard offered here will encourage efficient contracting. Where a party to a long-term contract engages in manipulation or other misconduct specific to that contract, that party has no legitimate expectation that its contract will be upheld, and it will know that in advance. By contrast, where a party is innocent of any wrongdoing, or where the wrongdoing did not specifically involve

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[4] In addition, where a seller develops market power, a buyer may file a complaint with FERC seeking to rescind the seller's authority to charge market-based rates. See *La. Energy & Power Auth.* v. *FERC*, 141 F.3d 364, 370-371 (D.C. Cir. 1998).

the long-term contract at issue, there is no economic justification for abrogating an agreement.

Economic efficiency is best served by encouraging long-term contracts, not impeding them. The Ninth Circuit's approach will deter energy suppliers from offering long-term contracts precisely when they are needed most. It will impede investment in badly needed energy infrastructure. Far from protecting utilities and consumers, the Ninth Circuit's standards will only exacerbate future energy crises.

CONCLUSION

The decision of the Ninth Circuit should be reversed.

Respectfully submitted.

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APPENDIX

APPENDIX
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